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ALTERNATIVES TO RISK MANAGEMENT POLICIES: VIEW FROM THE COUNTRY

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Weather. Price. Revenue. Income. Health. All are risks that farmers face as they go about the business of producing the food and fiber for this nation and many others. Farmers have long sought to reduce their risks, using a number of tools including ones taken on their own, through the private sector and some from the U.S. government.

Some ways to manage risk are as simple as the decisions made in a given farming operation. The annual decision of what crop mix to plant for the growing season is one of the most basic of risk management tools used by producers. A crop-based producer wanting to maximize income will look at a cropping mix from a different perspective than a livestock producer who actually needs to use the commodities grown as a basic need for the farming operation.

The U.S. agriculture of the 1950s saw many areas of the U.S. Midwest with operations raising cattle, hogs, sheep, poultry and crops such as corn, soybeans, oats and hay needed to sustain that livestock production. Those broadly diversified operations were a form of risk management for the operator -- it would be most unlikely for prices/returns for all of the segments of the farm to be depressed at the same time. And consumption on the farm -- to sustain the farm family -- was another reason for the actions taken on the production side of the equation.

But as U.S. agriculture has evolved, these layers of diversification have been slowly pared. Many Midwestern farms have livestock buildings present but are standing empty as crop production has become more of a farming staple. And those farmers opting to go "strictly" to crop production had decisions to make on their cropping mix as they no longer had to consider that a portion of the crop -- sometimes a considerable amount -- was to be utilized as livestock. So from that perspective, their crop risk was more on production, than price when commodities were produced as part of a diversified operation.

Yet those risks to an operation are still there. Instead of needing to reserve say 30% of production on a farm just to feed horses when those were used to power the farm's equipment, now a farmer is faced with covering that "feed" in a fuel bill to operate the machinery that is used for planting, cultivating/spraying, harvesting, storing and marketing that crop or crops. That has moved crop production more onto the same footing as livestock production in terms of having both price and production risks.

For the price side of risk, a cash forward contract is one of the basic tools utilized by producers. Many utilize this function in marketing their farm's crop output. The forward contract can typically be entered at nearly any time of the year, with options ranging from "spot" or immediate delivery to deferred delivery such as new crop -- after the crop growing in the field or to be planted in the field is harvested.

Even though the price underlying the cash forward contract comes from the futures market, the producer can enter into the contract with the margin calls associated with a futures position. While the producer has capped out his price via the contract, he has also transferred the price risk to the elevator. In times as we are currently seeing, the use of the cash forward contract can lock in attractive and profitable prices for producers of corn, soybeans and wheat.

However, the cash forward contract can be limited in terms of the length of time that the producer can cover his production. Even though there are futures contracts trading that will cover the 2008 or even 2009 crop year, it is unlikely that the producer can utilize a cash forward contract to cover this production. This may be an area for policy-makers to explore in the future -- how to make this tool more available for producers to utilize. That may involve providing elevators or grain buyers some type of incentive to encourage them to offer coverage to a farmer further out than just one crop season or portions of two crop seasons.

When it comes to the production side of risk, farmers, the private sector and the government haven't been able to devise a way to make it rain -- or quit raining! The use of crop insurance with "buy-up" coverage has been an increasing tool producers use to help mitigate -- not eliminate -- their production and/or risk. The tools now available go beyond multi-peril losses such as wind or hail, but can help to address revenue shortfalls.

But expanded use of the various crop insurance tools has not come without some cost. As USDA notes, $3.1 billion was the average cost for the federal government over 2002-2005. Three-quarters of what the government spends is on premium subsidies to convince farmers to buy higher rates of coverage. Those subsidies have worked to bring more farmers into the program, including those in areas where they typically did not utilize the program as they rarely suffered crop damage severe enough to reap a payment. The advent and broadening of tools that address revenue and risk have attracted many producers into the program.

But despite the broad availability of crop insurance options and support via the farm program, much of this aid is targeted to program crops (feed grains, food grains, upland cotton and soybeans) sugar and dairy, as USDA points out.

Ad hoc disaster programs approved by Congress have injected still more risk minimization by the government. But as growers have discovered for losses suffered in the 2005 and 2006 crop years, this type of risk management is highly unpredictable. Many times the aid will get snared by other political concerns, keeping it as a non-guaranteed source of risk protection.

As we have seen the growth of risk management tools in recent years via the crop insurance program and the U.S. farm program, the concepts we now view as common often began as an idea among just a handful of people. Over time and as growing numbers of producers enjoyed success with a certain insurance tool, more and more growers flocked to these tools.

That is to say, perhaps the risk management tool that will become the future blueprint has yet to be "thought of" or devised. Or, perhaps it is already out there being used but not to what will eventually be its full potential. This means the U.S. should challenge itself to not just reserve the term "research" for lab or field experiments, but to research and develop the best tools for farmers to use as they seek to address the risks faced in their operations.

USDA's risk management paper laid out some suggested alternatives:

Alternative 1: Use the existing structure of farm programs, but make them more WTO consistent, reduce their effects on resource use and structure, and better target them to producers with the greatest need for assistance.

The direct payments started as the basis of the Freedom to Farm version of U.S. farm policy and have proven an effective way -- or at least a reliable way -- of delivering farm program benefits to producers. The structure put in place to the make payments has also been a way for USDA to deliver supplemental payments. If more funds were shifted away from the marketing loan program and Counter-cyclical payment (CCP) program and moved into direct payments, at least no new structure and software redesign would be required.

Farmers receiving direct payments would likely appreciate the simple aspect of this route as it would take little action on their part. Of course there are still other aspects of complying with farm program requirements that would still require a certain amount of actions, but growers would be mostly unfettered to respond more directly to market signals. Depending on the level of reduction in loan rates for the marketing loan program, grower use would likely decline as predicted by USDA. Of course, that's assuming that market prices would continue to be higher -- or at least remain at levels which would minimize outlays for the loan program.

However, shifting more dollars to farmers via the direct payment route would continue to provide fodder for those seeking to focus on the transfer of taxpayer dollars to farmers. Unless the increase in direct payments was accompanied by tighter to considerably tighter payment limits, this focus would continue to erode support for farm programs. Congress has so far proven unwilling to make major adjustments in the pay caps. As USDA correctly points out, the impacts are greatest in areas where cotton and rice production is prevalent. And southern lawmakers continue to turn back efforts to significantly tighten payment limits. So it's not clear that efforts to tighten payments would be successful.

USDA's proposal to eliminate farm program payments to those whose three-year average adjusted gross income was $200,000 or more continues to generate considerable questions and comments from our newsletter subscribers. And not all the growers who would be affected by such a shift in farm programs are the "big" producers. Clearly, even though commodity prices are currently strong, growers view such a proposal on payment limits as a potentially onerous situation that would increase their risk.

Removing the acreage restriction on fruits and vegetables on base acres would have to involve some type of compensation for current growers. Many current fruit and vegetable growers aren't looking for a direct payment and do not want to be brought under the farm program umbrella. Rather, as USDA has proposed in its farm bill, these growers seek to have funding put toward research and efforts like extra purchases of fruits and vegetables for government nutrition and feeding programs.

When talking about pay caps, it also continues a debate that has gone on for years. However, if current commodity prices are sustained for an extended period, that could reduce some of the resistance to altering farm program payment limitations and targeting of those payments.

Alternative 2: Replace marketing assistance loans and counter-cyclical payments with a program that pays producers based on revenue shortfalls.

Under this alternative, ending the marketing loan and CCP programs to put a revenue-based program in place would involve a significant shift in farm program spending. And, it would also increase the need for growers to become familiar with a new form of government farm programs. However, those currently using some type of revenue-based crop insurance program would have some idea of what would likely be involved with such a program.

The record-keeping requirements that would go along with a revenue-based program could be substantial, especially for growers with a more-diverse operation. Keeping farm programs simple can certainly be a factor in how programs are viewed by producers.

Those in the insurance industry, which include farmer-member groups such as Farm Bureau, would certainly have issues with a potential situation where their business could be ended or significantly curtailed. That could have economic impacts and add risk for producers.

And, some of the concepts proposed to date would further expose regional differences that exist in agriculture and keep some of those "north-south" divisions alive.

Alternative 3: Phase out marketing assistance loans, direct payments, and counter-cyclical payments, and use savings to expand crop insurance coverage, fund farm savings accounts and/or expand conservation, rural development, or other programs.

Expanding conservation programs in exchange for doing away with marketing assistance loans, CCPs and direct payments would certainly have the potential to lower farm program outlays. Increasing conservation program payments would no doubt be welcomed in farm country, especially if they were run in a way to maximize conservation benefits in exchange for payments.

The Conservation Security Program (CSP) would seem to be an excellent candidate for an expanded role in efforts to address risk in agriculture. The program has suffered a dimmed view in many areas of farm country given the relatively small level of funding that Congress has provided for USDA to operate the effort. To expand the program would have to be accompanied by a renewed effort to reacquaint farmers with the program.

Others such as the Environmental Quality Incentives Program (EQIP) would help target more livestock operations and help them meet what may well be higher environmental standards relative to programs run by other government agencies, such as the Environmental Protection Agency. The program has enjoyed a positive stance for the most part in farm country. While a program certainly doesn't have to be "popular" to be used, it certainly doesn't hurt in terms of implementation and farmer education.

No doubt European Union (EU) officials would welcome the "greening" of the American farm program as a nod to some of their concepts. The farm program under this type of shift would no doubt be easier to justify to taxpayers as it there could be a proven a benefit to the country from the practices undertaken in exchange for payments. Farmers and non-farmer environmentalists would be able to be partners in the process, changing what can at times has been an adversarial relationship.

Still, an increased role of environmental regulations could chase some producers from the program and that could in turn reduce some of the positive environmental benefits. That is at least one aspect of our current system in that those producers who do receive government payments have to undertake a certain level of land stewardship. Effectively chasing these producers from farm programs would increase their risk and force them to concentrate more on private-sector approaches to risk management.

The bottom line remains that no matter what type of changes are to be contemplated for U.S. farm policy in terms of helping producers address the risks they face, they must provide a benefit to the farmer -- ideally financially address price/revenue risks -- while protecting the integrity of the program with the American taxpayer.

As with any of the possibilities suggested by USDA, there are always the times of unintended consequences. The current situation with ethanol is one of those cases. The demand base created by ethanol production has given corn, soybean and wheat producers profitable pricing opportunities. But those profitable price levels are creating issues for livestock producers as they see their feed costs rising. That will be the major test of any change in direction for U.S. farm programs -- who will be the winners and losers.